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October 12, 2021

Chairwoman Lea Márquez Peterson
Commissioner Sandra D. Kennedy
Commissioner Justin Olson
Commissioner Anna Tovar
Commissioner Jim O'Connor

ARIZONA CORPORATION COMMISSION
1200 West Washington Street Phoenix,
Arizona 85007

RE: Arizona Public Service Company (APS or Company)
Application for Approval of Rates, Charges, and Schedules
Docket No. E-01345A-19-0236

Dear Chairwoman Márquez Peterson and Commissioners:

In last week's Open Meeting, several questions were asked about my comments regarding possible downgrades of the Company's credit ratings as a result of the proposed ROE and further inaction on the Four Corners SCRs. In an effort to be responsive to those questions, APS last Friday docketed an analyst report from Guggenheim. Today, we are providing the attached report from Fitch, which announces their downgrade of the Company's credit rating from A- to BBB+. I note that Fitch indicates in their report that a further downgrade of the Company's credit rating is likely if the Commission continues on its current path with regard to both the Company's ROE and lack of resolution on SCRs.

As I stated in the Open Meeting, these downgrades of the Company's credit rating will result in higher borrowing costs for the Company—costs which will be borne by our customers, and which will hamper our ability to build the infrastructure necessary to support economic growth.

Let me know if you have any questions.

Sincerely,

Jeffrey B. Guldner

cc: Docket Control

ACC - Docket Control - Received 10/12/2021 4:49 PM
ACC - Docket Control - Docketed 10/12/2021 4:59 PM

12 OCT 2021

Fitch Downgrades Pinnacle West Capital & Arizona Public Service to 'BBB+'; Outlooks Remain Negative

Fitch Ratings - Chicago - 12 Oct 2021: Fitch Ratings has downgraded the Issuer Default Ratings (IDRs) of both Pinnacle West Capital Corp. (PNW), and its regulated utility subsidiary, Arizona Public Service Co. (APS) to 'BBB+' from 'A-'. The Rating Outlook remains Negative for PNW and APS. Fitch has also downgraded the unsecured ratings of PNW and APS one-notch to 'BBB+' from 'A-' and to 'A-' from 'A', respectively. In addition, Fitch has affirmed the CP and short-term ratings of both PNW and APS at 'F2'.

The one-notch rating downgrade and Negative Outlook for PNW and APS reflect anticipation of an adverse final order in APS's pending general rate case (GRC), resulting pressure on credit metrics and a heightened risk profile. The rating action follows recent amendments to the Administrative Law Judge's (ALJ) recommended order as voted on by the Arizona Corporation Commission (ACC) that, if finalized, would reduce rates at APS more than previously anticipated and lower its authorized ROE to 8.7% from 10%.

Absent future regulatory relief or management action to rebalance its capital structure, Fitch believes FFO leverage could deteriorate to 5.0x or more for PNW and APS in 2023. In that scenario, weaker credit metrics combined with significantly higher regulatory risk would likely result in future adverse credit rating actions.

A final GRC decision expected in late-October or early November along with clarity on management's capital spending plans and funding needs will be key factors in resolving the Negative Outlooks.

Key Rating Drivers

GRC Update: Fitch views ACC amendments to the ALJ's recommended order in APS's pending GRC that would result in a lower revenue requirement and significantly lower authorized ROE as punitive. Based on the ACC amendments, APS's authorized ROE would be reduced to 8.7% from 10% and recovery of investment in selective catalytic reduction (SCR) pollution controls at the Four Corners coal plant would be moved to a separate proceeding further delaying potential cost recovery. APS has been seeking recovery of SCR related costs since 2017.

While the ACC withdrew amendments to eliminate APS's fuel and purchased power adjustment mechanism, Fitch believes roll back of the cost recovery mechanism would significantly heighten business risk, underscoring the regulatory uncertainty facing APS.

Recommended ALJ Order: The ALJ recommendation calls for a revenue increase of $3.6 million based on a 9.16% ROE and an equity layer of 54.7%. APS had previously requested a revised revenue increase of $169 million based on a 10% ROE and an equity layer of 54.7%. Costs associated with the SCR's accounted for nearly half of the requested rate increase. Fitch notes that the recommended ROE of 8.7% is meaningfully below the 2020 national average of 9.4% for electric utilities and materially below APS's current authorized ROE of 10%.

Fitch's rating case reflects recent amendments to the ALJ recommended order as voted on by the ACC. The outcome of the GRC will be a key determinant of credit quality, this being APS's first rate case before the ACC in over three years based on a rate base that is 33% higher than the prior rate case.

Growing Regulatory Headwinds: Recent efforts by regulators to reduce rates, lower authorized returns and promote retail competition highlights the deterioration of the regulatory compact in Arizona. A series of recent decisions by the ACC that has delayed rate recovery and exacerbated regulatory lag have had negative implications for APS's and PNW's credit quality. In Fitch's view, recent amendments to the ALJ's recommended order by the ACC to lower rates and authorized returns, continued delays in approval of the second-step Four Corners rate increase, a recent proposal to remove the fuel and purchased power adjustor among other tracking mechanisms and an investigation into the prudency of the Solana PPA underscores regulatory risk and could result in future adverse credit rating actions.

Weakening Credit Metrics: Assuming APS receives a final order in its GRC consistent with recent ACC amendments, Fitch estimates FFO leverage metrics at both PNW and APS could weaken to 5.8x and 5.3x, respectively, by 2023, supporting the downgrade and Negative Outlook.

Large Utility Capex Program: Fitch expects capex to be elevated throughout the forecast period. Fitch notes that management has lowered the pace of its capital spending program relative to last year as it navigates an increasingly challenging regulatory environment. PNW is targeting average annual utility capex of $1.5 billion in 2021-2023, levels approximately 22% higher than the preceding three-year period but approximately $600 million less than the prior plan.

PNW is focused on achieving a cleaner generation mix while modernizing the electrical grid and spending levels support average rate base growth of 6% through 2023. Capex is earmarked for new generation, distribution and transmission investments including increasing solar generation with battery storage. Generation and distribution investments represent the lion's share of capex, accounting for approximately 75% of total expenditures.

Going forward, PNW plans to align its utility generation mix with Arizona's energy policy goals by divesting its coal fleet by 2031 and investing in new gas-fired generation and solar-battery storage investments. Due to its large capex program, Fitch expects FCF to be moderately negative through 2023, funding the majority of projected capex internally. PNW's external capital needs are expected to be funded by a balanced mix of debt and equity.

Clean Energy Plan: On Jan. 22, 2020, APS announced a self-imposed goal to deliver 100% clean, carbon-free electricity to its customers by 2050. In addition, APS intends to achieve a 2030 resource mix that is 65% clean energy with 45% from renewables while ceasing all coal-fired generation operations by 2031. The company's latest Integrated Resource Plan highlights the need for approximately 2,500MW of renewable energy, demand response, energy efficiency and energy storage resources over the next five years. The clean energy plan is consistent with the ACC proposals for increased renewable standards and should garner support from stakeholders who have been advocating for a cleaner energy future in Arizona.

Strong Economy in Arizona: Economic conditions are strong in Arizona. The utility continues to benefit from strong demographic trends including accelerated customer and retail sales growth. Customer growth approximated 2.3% and retail sales growth of 5.7% during the second quarter.

Parent and Subsidiary Linkage: Operating utility APS accounts for virtually all of parent PNW's consolidated earnings and cash flows. As such, Fitch applies a bottom up, weak parent-strong subsidiary approach in assessing parent-subsidiary rating linkage, reflecting PNW's dependence on APS to meet its obligations. APS's ratings reflect its standalone credit profile, while PNW's ratings reflect a consolidated credit profile.

Strategic and operational ties between PNW and APS are strong and include common call centers and a shared treasury team while legal ties are weak due to regulatory ring- fencing provisions at the utility. Financial ties are moderate as APS has direct access to debt capital markets, but is reliant on equity from its corporate parent. Overall, Fitch assesses parent subsidiary linkage as weak. Consequently, Fitch considers the maximum difference between the IDRs of APS and PNW to be two notches. However, PNW's IDR is the same as APS's, reflecting required support from the utility to meet corporate parent obligations and dependence of APS on equity infusions from PNW and the structural subordination of PNW's debt relative to APS.

ESG Relevance factor that is a Key Rating Driver

ESG Factors: Fitch has revised the ESG relevance score to '5' for '4' for both Social - Human Rights, Community Relations, Access & Affordability and Social - Customer Welfare-Fair Messaging, Privacy & Data Security factors for both PNW and APS to reflect recent deterioration in the regulatory environment in Arizona and expectations for a challenging decision in APS's pending GRC. Regulatory risk has increased following a recent decision by the ACC to reduce customer rates and authorized returns. This has a negative impact on the credit profile and is relevant to the ratings in conjunction with other factors.

Derivation Summary

Pinnacle West Capital Corp.:

Pinnacle West Capital Corp.'s credit profile is in line with lower rated peer utility parent holding companies DTE Energy Co. (BBB/Stable) and CMS Energy Corp. (BBB/Stable). A weakening financial profile resulting from regulatory lag due to a deteriorating regulatory environment has pressured credit metrics, which are in line with 'BBB' peers. While the regulatory environment in Michigan remains supportive, the regulatory environment in Arizona has become challenging as evidenced by the punitive recommended order in APS's pending GRC and recent amendments voted out by the commission. For 2020, FFO adjusted leverage at PNW was 5.6x, worse than DTE at 4.7x but better than CMS at 6.3x.

PNW's business risk profile reflects ownership of sole subsidiary APS Co. and is comparable to peers with predominantly electric operations in single state jurisdictions. PNW's regulated utility operations comprise 100% of EBITDA and its business risk is similar to CMS -- which derives approximately 95% of EBITDA from its regulated utility and DTE -- which derives more than 90% of EBITDA from regulated utility businesses. In terms of scale, PNW's utility operations are the largest in Arizona with total assets of $21 billion as of 2020 but are smaller in size relative to CMS and DTE. DTE and CMS are the largest utility providers in Michigan with total assets of $50 billion and $30 billion as of 2020, respectively.

Arizona Public Service Company:

The credit profile of APS is weaker than utility peers DTE Electric Co. (A-/Stable) and Florida Power and Light Co. (A/Stable). APS's credit profile is comparable with peers that have sizable electric utility operations in single-state jurisdictions with historically constructive regulatory environments. The regulatory environment in Arizona has deteriorated meaningfully becoming significantly more challenging from a credit perspective compared to Michigan or Florida. The ACC appears to be focused on potential overearnings and reducing customer rates. This is most evident in the ALJ's unfavorable recommended order in APS's latest GRC and recent amendments by the ACC to the ALJ's recommended order.

Credit metrics for APS are weaker than peers due to regulatory lag resulting from a protracted GRC proceeding during a period of heavy capex. For 2020, FFO adjusted leverage at APS was 5.2x, worse than DTE Electric at 3.9x and Florida Power and Light Co. at 2.9x. In terms of scale, APS's utility operations are the largest in Arizona but smaller relative to DTE Electric and Florida Power and Light

Key Assumptions

--Assumes a rate reduction based on 8.7% ROE;

--Continued customer growth averaging 2% per annum;

--Capex averaging $1.5 billion per annum through 2023.

RATING SENSITIVITIES

PNW:

Factors that could, individually or collectively, lead to positive rating action/upgrade;

--A positive rating action is unlikely at this time given the Negative Outlook;

--However, improvement in the regulatory compact in Arizona could stabilize the Negative Rating Outlook;

--Sustained FFO leverage of better than 4.0x along with an improving regulatory compact could lead to a favorable rating action.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Continued deterioration in the regulatory compact in Arizona.

--A material increase in parent-level debt;

--A downgrade at APS;

--Sustained FFO leverage greater than 5.0x.

APS:

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--A positive rating action is unlikely at this time given the Negative Outlook;

--However, improvement in the regulatory compact in Arizona could stabilize the Negative Outlook;

--Sustained FFO leverage of better than 4.0x along with an improving regulatory compact could lead to a favorable rating action.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Continued deterioration in the regulatory compact in Arizona;

--Sustained FFO leverage greater than 5.0x.

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

Liquidity and Debt Structure

Sufficient Liquidity: Fitch considers liquidity for PNW to be adequate with $709 million of available liquidity under its consolidated credit facilities as of June 30, 2021, including $14 million of unrestricted cash and cash equivalents. PNW's liquidity is provided by a $200 million unsecured credit facility that matures in May 2026 and a $150 million term loan that matures in June 2022. APS's liquidity is provided by two $500 million unsecured credit facilities that mature in May 2026. These facilities support its $750 million CP program. PNW and APS can upsize their $200 million and $500 million credit facilities to $300 million and $700 million, respectively, with lender consent.

The credit facilities are subject to a maximum debt/capitalization covenant of 65% and as of June 30, 2021, PNW and APS complied with debt/capitalization ratios of 55% and 50% as defined under the agreement. APS requires modest cash on hand and, being a summer peaking utility, capital needs are typically highest during the second and third quarters. PNW's long-term debt maturities are minimal over the next five years and includes $250 million in 2024 and $300 million in 2025 at APS.

Issuer Profile

PNW is a parent holding company which derives virtually all of its revenue from its wholly owned sole operating subsidiary, APS. APS is a regulated vertically integrated electric utility, serving 1.3 million customers in a 34,646-square-mile service territory. APS is the largest electric utility in Arizona and serves most of the Phoenix metropolitan area.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

ESG Factors: We have revised the ESG relevance score to '5' for '4' for both Social - Human Rights, Community Relations, Access & Affordability and Social - Customer Welfare-Fair Messaging, Privacy & Data Security factors for both PNW and APS to reflect recent deterioration in the regulatory environment in Arizona and expectations for a challenging decision in APS's pending GRC. Regulatory risk has increased following a recent decision by the ACC to reduce customer rates and authorized returns. This has a negative impact on the credit profile and is relevant to the ratings in conjunction with other factors.

In 2019, both PNW and APS were assigned an ESG relevance score of '4' for Social issues following complaints of excessive bills by customers following the implementation of time-of-use rates. Regulators have found that customer education and outreach efforts were insufficient, which has led to increased regulatory scrutiny and the absence of rate recovery.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Arizona Public Service Company	LT IDR	BBB+ ⊖	Downgrade		A- ⊖
	ST IDR	F2	Affirmed		F2
• senior unsecured	LT	A-	Downgrade		A
• senior unsecured	LT	A-	Downgrade		A
• senior unsecured	ST	F2	Affirmed		F2
Pinnacle West Capital	LT IDR	BBB+ ⊖	Downgrade		A- ⊖

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Corporation					
	ST IDR	F2	Affirmed		F2
• senior unsecured	LT	BBB+	Downgrade		A-
• senior unsecured	ST	F2	Affirmed		F2

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Rating Criteria (pub.21 Dec 2020) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub.09 Apr 2021) (including rating assumption sensitivity)

Parent and Subsidiary Linkage Rating Criteria (pub.26 Aug 2020)

Sector Navigators - Addendum to the Corporate Rating Criteria (pub.30 Apr 2021)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

Arizona Public Service Company	EU Endorsed, UK Endorsed
Pinnacle West Capital Corporation	EU Endorsed, UK Endorsed

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